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No. 84-352

# In the Supreme Court of the United States

OCTOBER TERM, 1984

JOHN CODY, ET AL., PETITIONERS

*v.*

RAYMOND J. DONOVAN, SECRETARY OF LABOR, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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## QUESTIONS PRESENTED

1. Whether the district court abused its discretion in severing petitioners' third-party claims for separate trial.

2. Whether the district court abused its discretion in granting relief for a breach of fiduciary duties imposed by the Employee Retirement Income Security Act of 1974.

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-27a) is reported at 744 F.2d 270. The district court's memorandum of July 21, 1983 (Pet. App. 57a-80a) is reported at 568 F. Supp. 360. The district court's memorandum of December 7, 1983 (Pet. App. 98a-107a) is reported at 4 Empl. Ben. Cas. (BNA) 2613. The district court's memorandum of January 26, 1984 (Pet. App. 112a-119a) is reported at 4 Empl. Ben. Cas. (BNA) 2698. The district court's memoranda of April 5, 1983 (Pet. App. 30a-49a), April 15, 1983 (*id.* at 50a-56a), August 18, 1983 (*id.* at 81a-97a), and August 10, 1984 (*id.* at 133a-137a) are unreported.

### JURISDICTION

The judgment of the court of appeals was entered on June 29, 1984. A petition for rehearing was denied on July 26, 1984 (Pet. App. 1a-2a). The petition for a writ of certiorari

was filed on September 4, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Petitioners were trustees of the Teamsters Local 282 Pension Trust Fund and Welfare, Annuity and Legal Services Trust Funds. Separate actions against petitioners by participants in the Pension Fund and by the Secretary of Labor were consolidated in the United States District Court for the Eastern District of New York. Following a bench trial, petitioners were removed from their positions and held jointly and severally liable to the Pension Fund for losses resulting from breaches of their fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.* (Pet. App. 57a-80a, 98a-107a). With the exception of a provision of the district court's order relating to appointment of a fund manager, the court of appeals affirmed (*id.* at 3a-27a).

a. The evidence at trial showed that petitioners approved a $2 million loan from the Pension Fund to Des Plaines Bancorporation for its wholly owned subsidiary, the Des Plaines Bank. Representatives of Bancorporation made a two-hour presentation to petitioners on February 27, 1979, discussing the highlights of certain of their financial statements. Although petitioners possessed neither accounting nor banking expertise, they did not obtain independent professional analysis of the data. Following further discussions with two of the trustees, loan documents were signed on March 1, 1979. The loan agreement provided for repayment in semi-annual installments of $125,000 plus interest, with a final balloon payment after four years of $1.125 million. Interest was payable at 1% over the prime rate. Security for the loan was 95% of the Bank's outstanding stock as well as certain property owned in part by Bancorporation's president. Pet. App. 9a-11a.

The Pension Fund received three of the required payments. On March 14, 1981, the Bank was closed by federal and state regulatory officials, and no further payments were made. At that time, Bancorporation owed the Pension Fund $1.625 million, plus interest from September 1980. Pet. App. 11a.

b. The courts below concluded that petitioners breached their fiduciary duties under ERISA's prudent-man standard in connection with the loan.[1] As summarized by the court of appeals (Pet. App. 19a):

> The trustees, being ill-equipped to evaluate the soundness of the proposed loan, failed to observe their duty to seek outside assistance. They relied exclusively on the representations of Bancorporation, the borrower, as to its financial strength and reached an investment decision after wholly inadequate inquiry and deliberation. A reasonable investigation would have revealed evidence that the loan was totally unsound.

Among the "red flags" (*id.* at 12a) that an appropriate inquiry would have uncovered were the Bank's extremely low equity/asset ratio, its tangible net worth of one-quarter the amount of the loan, an abnormal rise in the amount of its loans, its difficulty in meeting payments on another loan and in obtaining funds elsewhere, and criticism of the Bank's operations by officials of the Federal Deposit Insurance Corporation shortly before Bancorporation's meeting with petitioners (*id.* at 12a-13a, 71a-76a).

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[1] 29 U.S.C. 1104(a)(1) provides:

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —
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> * * * * *
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims * * *.

c. Following a hearing on relief, the district court held petitioners liable to the Pension Fund for $2.5 million to compensate for the Fund's loss in connection with the Bancorporation loan (Pet. App. 101a).[2] The court also removed petitioners from their positions as trustees of the various Funds (*id.* at 104a-107a, 122a). The court of appeals affirmed the relief, except with respect to the term of a fund manager appointed by the district court (*id.* at 22a-27a).

2. Following commencement of the actions against them, petitioners filed third-party claims against Bancorporation's directors and counsel, alleging common-law fraud and misrepresentation in connection with the loan.[3] In a pretrial order, the district court severed the third-party claims pursuant to Fed. R. Civ. P. 42(b) because they were still at a preliminary stage and a delay in trying the main actions would "substantially prejudice the rights of the plaintiffs" (Pet. App. 48a). The court rejected petitioners' argument that all of the actions must be tried together to a jury in order to preserve their jury-trial right with respect to

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[2]This amount included $1.625 million in unpaid principal, $700,000 in unpaid interest as provided in the loan agreement, $142,000 in interest at the prime rate for the nine months from the date of maturity of the loan to judgment, and $32,000 in prior uncollected interest. The court also held petitioners (except for Guercia, who was not a trustee at the relevant time) liable for $23,000 in connection with an unrelated transaction. Pet. App. 101a.

[3]Petitioners also alleged violations of the securities laws; these were dismissed for failure to state a claim (Pet. App. 90a, 97a). The Pension Fund, which had been joined as a defendant in the main actions, brought third-party claims seeking indemnification from the Bancorporation officials. These were dismissed as "inaccurately based upon notions of derivative liability" (*id.* at 89a-90a, 97a). The Fund subsequently filed an independent action against the officials in the United States District Court for the Northern District of Illinois. That case was dismissed on grounds of collateral estoppel arising out of the main actions (*id.* at 125a-132a; 585 F. Supp. 1401, appeal docketed, No. 84-2141 (7th Cir. July 11, 1984)).

the third-party claims under *Beacon Theatres, Inc.* v. *Westover*, 359 U.S. 500 (1959). The court reasoned that "[t]he issues in the actions against [petitioners] are not the same as the issues in the third-party actions" (Pet. App. 40a) and so collateral estoppel would not foreclose petitioners' access to a jury on their claims against the Bancorporation officials (*id.* at 39a-42a). The district court subsequently transferred the third-party claims to the United States District Court for the Northern District of Illinois, where they are currently pending (*id.* at 133a-137a).

## ARGUMENT

Petitioners contend that the actions against them and their third-party action raised common issues requiring resolution by a jury and that the relief granted by the district court was excessive. These largely factbound claims were correctly rejected by the courts below. Further review is unwarranted.

1. Petitioners contend (Pet. 9-14) that severance of their third-party claims for later trial was improper under *Beacon Theatres*.[4] There, the Court held that where legal claims and equitable claims in the same action raise identical issues of material fact, the legal claims normally should be tried first. 359 U.S. at 510-511. This rule is designed to preserve the right to a jury determination of the legal claims in view of the possibility that later litigation before a jury might be precluded by the court's determination of the facts in connection with the equitable claims. See *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 333-334 (1979).

This principle is inapplicable here, because the issues decided in the main actions are for the most part irrelevant to the third-party claims. The basic question in the main

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[4]Petitioners do not press their claim, rejected by the courts below (Pet. App. 17a-18a, 34a-39a), that they were independently entitled to a jury trial of the claims against them.

actions was whether the trustees conducted themselves as prudent persons within the meaning of 29 U.S.C. 1104(a)(1)(B) (note 1, *supra*) in deciding to make the loan to Bancorporation. This issue is wholly irrelevant to petitioners' fraud claims, as they appear to admit (Pet. 12 n.8). See Restatement (Second) of Torts §§ 540, 545A (1977) (recipient of fraudulent information is justified in relying on it even if its falsity might have been ascertained by investigation; action is not barred by the recipient's contributory negligence). And while contributory negligence may bar recovery for negligent misrepresentation (*id.* § 552A), whether petitioners would be barred under this doctrine was not actually decided in the main actions. Rather, the district court found simply that petitioners failed to meet the high standard of care imposed by ERISA upon trustees (Pet. App. 69a-70a). Petitioners remain free to argue that they did satisfy the standard of care required of them to recover for common-law misrepresentation.[5] Accordingly, collateral estoppel should not operate to deprive petitioners of a jury trial on their third-party claims.[6]

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[5]See generally Restatement (Second) of Trusts § 227 comment e (1959) ("[i]n making investments not only is the trustee under a duty to use due care and skill, but he must use the caution of a prudent man"); G. Bogert, *The Law of Trusts and Trustees* § 541, at 167 (rev. 2d ed. 1978) (discussing higher standard of care for professional trustees); *Donovan* v. *Mazzola*, 716 F.2d 1226, 1231 (9th Cir. 1983), cert. denied, No. 83-598 (Jan. 9, 1984) ("in enacting ERISA Congress made more exacting the requirements of the common law of trusts relating to employee benefit trust funds"); *Donovan* v. *Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.), cert. denied, 459 U.S. 1069 (1982) (duties of trustees under ERISA are "the highest known to the law").

[6]The decision foreclosing litigation by the Pension Fund (see note 3, *supra*) is, we submit, based on an incomplete analysis of the issues; the court focused primarily on whether the Fund participated in the earlier litigation sufficiently to be estopped (see Pet. App. 129a-132a). In any event, it would make little sense to vacate an otherwise valid judgment and remand for a new trial simply because a different court in a distinct

Even if collateral estoppel might arise, the decision of the district court severing the third-party claims for later trial was nonetheless correct. The need to prevent irreparable harm to the Pension Fund's participants arising from its direction by trustees who had violated the trust reposed in them dictated a trial at the earliest possible time.[7] Moreover, the actions against petitioners were ready for trial while "the third party claims were still early in discovery; indeed, not all of the third parties had been served, much less deposed or subjected to discovery requests" (Pet. App. 16a). Under these circumstances, the "general prudential rule" (*Parklane Hosiery*, 439 U.S. at 334) of *Beacon Theatres* must give way, as the Court recognized in *Beacon Theatres* itself (359 U.S. at 510). See *Katchen* v. *Landy*, 382 U.S. 323, 339-340 (1966) ("[b]oth *Beacon Theatres* and *Dairy Queen* [v. *Wood*, 369 U.S. 469 (1962),] recognized that there might be situations in which the Court could proceed to resolve the equitable claim first even though the results might be dispositive of the issues involved in the legal claim").

2. Petitioners contend (Pet. 14-23) that the relief ordered by the district court was excessive. It is, however, "well-settled that ERISA grants the court wide discretion in fashioning equitable relief to protect the rights of pension

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action disagrees with the first court's reasonable prediction concerning the scope of its own judgment. We note that the problem arose here solely because of the transfer of the legal claims to another court, a situation unlikely to arise with great frequency.

[7]Most of the petitioners had committed other serious violations of ERISA in the past. See *Marshall* v. *Teamsters Local 282 Pension Trust Fund*, 458 F. Supp. 986 (E.D.N.Y. 1978). Indeed, petitioner Cody, who by virtue of his economic power over the other trustees possessed complete control over the Pension Fund, had been convicted under the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. 1961 *et seq.*) in connection with his receipt of kickbacks as a fiduciary of the Pension Fund. Pet. App. 102a-103a.

fund beneficiaries" (Pet. App. 22a).[8] See, *e.g.*, *Donovan* v. *Mazzola*, 716 F.2d 1226, 1235 (9th Cir. 1983), cert. denied, No. 83-598 (Jan. 9, 1984); *Eaves* v. *Penn*, 587 F.2d 453, 462 (10th Cir. 1978). In view of petitioners' misconduct, the relief awarded was well within this discretion. Petitioners' argument that the courts below erred in applying settled law to the facts of this case does not warrant this Court's review.

Removal of petitioners from their positions, a remedy expressly authorized by 29 U.S.C. 1109 (note 8, *supra*), was wholly proper in light of the violations found by the courts below. See Pet. App. 23a-24a; *Mazzola*, 716 F.2d at 1238-1239; *Marshall* v. *Snyder*, 572 F.2d 894, 901 (2d Cir. 1978). Petitioners' attempt to reargue the facts (Pet. 15-18) by suggesting that only a "mere error of judgment" was involved must fail (see pages 2-3, *supra*). The award of prejudgment interest was proper in view of the fact that hundreds of other banks were willing to borrow funds at the same rate (Pet. App. 22a-23a). Accordingly, the award of interest merely put the Fund in the position it would have occupied but for petitioners' improvident loan to Bancorporation. See 29 U.S.C. 1109; *Mazzola*, 716 F.2d at 1232-1233, 1235; Restatement (Second) of Trusts § 205 &

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[8] 29 U.S.C. 1109(a) provides:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. * * *

comment a (1959).[9] Finally, contrary to petitioners' unsupported contention (Pet. 22), there is no requirement that all set-offs be incorporated into a single judgment. Cf. Fed. R. Civ. P. 13(i). Credits in favor of petitioners reflecting recovered funds will amply protect their interests.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[9] In the *Bierwirth* case, relied upon by petitioners (Pet. 20-21), the court ultimately determined that the pension fund there had not suffered any loss; accordingly, no issue of prejudgment interest was presented. See 5 Empl. Ben. Cas. (BNA) 1065 (E.D.N.Y. Feb. 21, 1984), appeal pending, No. 84-6130 (2d Cir.). In any event, there is no requirement that the courts' equitable discretion be exercised in an identical fashion in every case.

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